

Appeal from a decision of the Acting Associate Director for Policy and Management Improvement, Minerals Management Service, denying on procedural grounds an appeal from a Minerals Management Service order to pay \$98,434.46 in royalties and \$41,671.10 in late fees deemed owing after an audit of settlement agreements regarding gas produced from Federal oil and gas leases. MMS-95-0302-O&G.

Reversed, underlying order affirmed.

1. Administrative Procedure: Generally--Appeals--Rules of Practice: Appeals: Generally

When MMS rejects an appeal to the Director for failure to set forth substantive reasons why the appellant believed the royalty assessment to be incorrect and it is found that sufficient reasons were before MMS when the decision was rendered, the Board has discretion to remand the case or to adjudicate the merits of the appeal. The Board will address the merits when no practical benefit would result from the remand of the case, and, in all probability, the dispute would be appealed to the Board again after remand.

2. Oil and Gas Leases: Royalties: Generally

Under the decision of the Court of Appeals for the Sixth Circuit in In re Century Offshore Management Corp., 111 F.3d 443 (6th Cir. 1997), an up-front, lump sum settlement payment made in exchange for a substituted contract that changed the price of the old contract, when the same amount of gas was delivered to the same purchaser as would have occurred under the old contract, is sufficient to qualify as "production sold" and royalty was payable on the payment when the gas was produced.

APPEARANCES: Richard T.C. Tully, Esq., Farmington, New Mexico, for appellant Western Oil and Minerals, Ltd.; Peter Schaumburg, Esq., Howard W. Chalker, Esq., Geoffrey Heath, Esq., Sarah Inderbitzen, Esq., and Lisa Hemmer, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE MULLEN

Western Oil and Minerals, Ltd. (Western), has appealed an October 31, 1996, decision issued by the Acting Associate Director, Policy and Management Improvement, Minerals Management Service (MMS), rejecting Western's appeal from an order of the Lakewood Compliance Division, MMS, directing Western to pay \$98,434.46 in royalties and \$41,671.10 in late fees.

Western and El Paso Natural Gas Company (El Paso) entered into two gas contract settlement agreements, dated July 1, 1987, and March 8, 1989, regarding performance under contracts for purchase and sale of gas produced from Western wells. Under the settlement agreements Western received lump sum payments from El Paso in return for future price reductions. No royalty was paid on the lump sum payment.

Following settlement, MMS conducted an audit to determine whether settlement proceeds were attributable to production from the Federal leases and whether additional royalties were due. In a preliminary report dated December 6, 1994, MMS advised Western that it construed these "buydowns" as modifying the gas purchase agreement through volume price restructuring, resulting in a royalty underpayment. After considering Western's response, MMS issued an order on January 20, 1995, directing Western to pay the royalty underpayment amount and late-payment charges. Western appealed to the Office of the Director, MMS, pursuant to 30 C.F.R. Part 290.

In its appeal to MMS, Western stated that

[t]his action stems from the fact that * * * official enforcement actions attempting to collect royalties on gas contract settlements are being challenged in various administrative proceedings as well as in the courts. See, e.g., IPAA [Independent Petroleum Association of America] v. Babbitt, C.A. No. 94-0393 (D.D.C.); Mobil Exploration and Producing U.S. Inc. v. Babbitt, C.A. No. 94-0393 (D.D.C.); Samedan Oil Co. v. Deer, C.A. No. 94CV021239 (D.D.C.).

* * * * *

[W]estern hereby requests a refund of the gas royalty payments and late payment charges being tendered herewith, such refund to occur if the outcome of the above-referenced litigation is unfavorable to the Department of the Interior.

(Feb. 27, 1995, Letter to MMS; see also May 11, 1995, Letter to MMS.) Noting that a statement of reasons which does not, with some particularity, allege error in the decision cannot be afforded favorable consideration, the Acting Associate Director for Policy and Management Improvement denied the appeal as follows:

The Appellant has offered no substantive analysis of why it believes the assessment of royalty is incorrect. The

Appellant apparently wishes to simply "piggy-back" on existing litigation in the event other parties contesting royalty assessments on other contract settlements are successful. That litigation is ongoing. In the absence of any showing of why royalty is not owed, the appeal must be denied.

(Oct. 31, 1996, Decision at 2.)

In its statement of reasons for appeal to this Board, Western disputes MMS' determination that it failed to state adequate reason for its appeal to MMS. Western argues that the basis for challenging the purported royalty underpayment was incorporated by reference to the "IPAA litigation," an action involving MMS. It explains that because of very limited resources, it could not afford to litigate this dispute through lengthy proceedings and therefore relied on the arguments made in the cases it cited. Western states that a judgment was rendered in the "IPAA litigation" on August 27, 1996, which was prior to the date of MMS' decision, and asserts that in the IPAA case the court held that a gas producer cannot be held to pay royalties on payments made pursuant to settlement agreements similar to its agreements with El Paso. It contends that the Department's position was rejected by the courts, and the MMS decision was therefore arbitrary, capricious, and inconsistent with applicable law. In response, MMS sought an extension of time to respond to Western's arguments, citing a 1997 decision to the contrary. No answer was filed, but the case cited in the request for an extension has been found to be helpful.

[1] In the decision on appeal the Acting Associate Director found that the Appellant offered no substantive analysis of why it believed the assessment of royalty was incorrect. Therefore we must consider whether Western presented adequate reasons for its challenge of the January 20, 1995, order directing Western to pay the underpayment amount and late-payment charges. As clearly shown, the IPAA decision addresses concrete issues regarding whether a royalty assessment is properly levied against settlement payments, and advanced a rationale for not assessing royalties in settlement situations before MMS when the appealed decision was rendered. This being the case, Western presented a reasonable basis for appeal. MMS should have adjudicated this appeal in the first instance, and its decision rejecting Western's appeal for failure to offer a substantive analysis of why it believed the assessment of royalty to be incorrect is reversed. However, the facts of this case are such that on remand, the Director, MMS would, in all probability, affirm the underlying order for reasons stated in the January 20, 1995, order, and thus the dispute would be before the Board again. When no useful purpose would be served by remanding the case, the Board will adjudicate the case on its merits. See Robert C. LeFaivre, 95 IBLA 26 (1986). By doing so, we will not only avoid procedural detours, which are unnecessary under the circumstances of this case, but we will provide a useful resolution of the substantive issue raised as well. See Beard Oil Co., 97 IBLA 66 (1987); Robert C. LeFaivre, *supra*; Benton C. Cavin, 93 IBLA 211, 212-13 (1986),

aff'd, Cavin v. United States, 19 Cl. Ct. 198 (1989); Kenneth W. Bosley, 91 IBLA 172, 175 (1986); United States v. Napouk, 61 IBLA 316, 322 (1982); Julie Adams, 45 IBLA 252, 254 (1980); California Ass'n of Four Wheel Drive Clubs, 30 IBLA 383, 387 (1977). Accordingly, in lieu of remanding this matter to MMS, we shall consider its merits.

[2] In its order directing payment of royalties and late fees, MMS set forth the basis for its determination:

The regulations at 30 CFR § 206.103 (1987), entitled "Value basis for computing royalties," state, in part:

Under no circumstances shall the value of production of any of said substances for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. * * *

The regulations at 30 CFR § 206.152(h) (1988), entitled "Valuation standards-unprocessed gas," state, in part:

[U]nder no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing to the lessee for lease production, less applicable allowances determined pursuant to this subpart.

The regulations at 30 CFR § 206.151 (1988), entitled "Definitions," define gross proceeds as follows:

"Gross proceeds" (for royalty payment purposes) means the total monies and other consideration accruing to an oil and gas lessee for the disposition of unprocessed gas, residue gas, or gas plant products.

* * * Therefore, when the lessee, in exchange for compensation, gives up gas purchase rights that would result in payment of royalties on gas produced from the lease if the gas had been disposed of under the original gas purchase agreements, the royalty owner is entitled to its fractional share of such compensation to prevent the unjust enrichment of the lessee.

(Jan. 20, 1995, Order at 2-3.) Construing the gas purchase agreements, amendments, and settlement agreements, MMS deemed the settlement proceeds to be related to future price reductions, noting that, under the settlement agreements, Western sold a minimum dedicated quantity of gas to El Paso at the revised prices during the term of the original gas purchase agreement

(the period from March 8, 1989, to September 1, 1992). In worksheet documents attached to the order, MMS apportioned the royalty and interest among the seven leases involved, based upon the gas produced from each well during the period.

As noted, appellant asks the Board to adopt the decision in IPAA v. Babbitt, 92 F.3d 1248 (D.C. Cir. 1996). In that case, the United States Court of Appeals for the District of Columbia Circuit began its discussion with an outline of fundamental changes in the gas industry which fueled the controversy leading to situations similar to those we are now addressing. Id. at 1251-53. Prior to 1989 wellhead pricing was strictly regulated and producers entered into long-term, fixed price purchase contracts. Congress deregulated wellhead gas prices in the Natural Gas Wellhead Decontrol Act of 1989, Pub. L. No. 101-60, 103 Stat. 157, and market prices for gas dipped substantially below the long-term contract prices buyers had agreed to pay. In most instances the buyers were obligated under the take-or-pay provisions in the contracts to pay even when they did not take gas and, when their customers turned to cheaper supply sources, the purchase contracts became a burden to the purchasers under the long-term contracts. Most producers and buyers resolved this take-or-pay problem by restructuring of the purchase contracts and payment of a lump sum amount to the seller. These settlement payments were usually one of two types--"buydowns" and "buyouts." In a buydown, the settlement resulted in the continued sale of the contracted-for gas at a reduced price. In a buyout, the buyer was released from the contract and the producer could sell gas elsewhere.

Much of the production effected by the settlement agreements came from lands subject to Federal gas lessees. The Department's general rule on royalties, found at 30 C.F.R. § 206.103 (1987) and known as the "gross proceeds rule," provided that the value of production for royalty purposes could not be less than the gross proceeds accruing to the lessee, and MMS held that royalty was due for settlement payments. IPAA, supra at 1252. In January 1988, the Department issued a new definition of "gross proceeds" to account for the take-or-pay settlement payments:

Gross proceeds as applied to gas, also includes but is not limited to: Take-or-pay payments * * *. [P]repaid reserve payments that are subject to recoupment through credits against the purchase price or through reduced prices in later sales and which are made before production commences become part of gross proceeds as of the time of first production.

Revision of Gas Royalty Valuation Regulations and Related Topics, 53 Fed. Reg. 1230, 1275 (Jan. 15, 1988) (promulgating 30 C.F.R. § 206.151 (1988)).

The immediate payment of royalty accruing on take-or-pay settlement payments was challenged in Diamond Shamrock Exploration Co. v. Hodel, 853 F.2d 1159 (5th Cir. 1988). The court reasoned that the mineral leasing statutes contemplate royalties on gas actually produced and taken, that take-or-pay

payments result from a buyer's failure to take gas, and they are not a payment for gas actually produced. The court held that royalties are due only for production physically severed from the ground. Rather than seeking review of the decision, the Department amended the gross proceeds rule by deleting the above quoted language. Revision of Gross Proceeds Definition in Oil and Gas Valuation Regulations, 53 Fed. Reg. 45,082, 45,084 (Nov. 8, 1988); see 30 C.F.R. § 206.151 (1989).

In October 1994, Samedan Oil Corporation sued the Department disputing its decision to collect royalties on a buyout settlement between Samedan, an Indian lands lessee, and Southern Natural Gas Company. The buyout settlement terminated a 10-year sales contract in exchange for a "nonrecoverable and nonrefundable" payment in "resolution and full and final settlement of any and all obligations and liabilities that Southern has or may have under the Contract." IPAA, supra at 1254. By 1989, Samedan had sold all the gas which would have been sold to Southern under the terminated agreement, but Southern purchased none of it. After conducting an audit, MMS ordered Samedan in May 1993 to pay royalties on the settlement payment and that order was affirmed by an Assistant Secretary, MMS. The district court concluded that the MMS order was not inconsistent with Diamond Shamrock, supra, and affirmed. IPAA, supra at 1255. However, on appeal, the court of appeals took a different view and reversed. The court's decision to reverse in IPAA does not prejudice MMS' action in this case, however.

In IPAA, the court began its analysis with

an examination of the basis for the holding in Diamond Shamrock.

The Fifth Circuit placed heavy emphasis on the necessary link between royalties and actual production of gas, finding it "obvious" from the relevant statutes, regulations and lease provisions that royalties "are not due on 'value' or even 'market value' in the abstract, but only on the value of production saved, removed or sold from the lease property." Diamond Shamrock, 853 F.2d at 1165. Similarly, the court determined that the gross proceeds rule applies "only to gross proceeds that accrue to the lessee from the disposition or sale of produced substances, that is, gas actually removed and delivered to the pipeline." Id.

IPAA, supra at 1258. The court further explicated:

Under Diamond Shamrock, at the time of a settlement payment or a take-or-pay payment, no production has occurred; therefore no royalties accrue. But when make-up gas is taken, a portion of the take-or-pay payment is credited as payment for the make-up gas. It is therefore reasonable to collect royalties on these funds, which have been transformed into payments for gas produced.

That is what the Fifth Circuit relied upon in its Diamond Shamrock decision--the existence of a direct link between the funds upon which royalties are imposed and the physical severance of gas.

Id. Thus, the court concluded: "Neither take-or-pay payments nor take-or-pay settlement payments are royalty bearing unless and until they are credited toward the purchase of make-up gas." Id. at 1260.

In his dissenting opinion, Judge Rogers found that MMS had further distinguished four types of settlement payments, which he described as:

"Past pricing disputes" relate to the amount owed for minerals produced or sold before the contract settlement, and such amounts are subject to royalty when the payment is made. A "contract buydown" involves a payment made to reduce the price of gas to be taken in the future (after the settlement) by the original purchaser--"it is paying a lower price later"--and such payments are royalty-bearing as future production occurs. * * * [A] "buyout" payment extinguishes the purchaser's obligation to take any gas in the future, and is royalty-bearing because "it compensates the lessee for lower prices in the future for the production foregone by the original purchaser." * * * Finally, payments in settlement of accrued take-or-pay liabilities are royalty-bearing, at the time of production, as attributed to each unit of gas up to the volume of what would have been make-up gas.

Id. at 1262-63 (footnotes omitted). Judge Rogers then found that the first two settlement types were not addressed in the IPAA decision and therefore those settlements should not be construed as being within that court's analysis. The Western and El Paso agreement now before us falls within the category of settlements not considered in IPAA.

Within the following year, the United States Court of Appeals for the Sixth Circuit had the opportunity to review MMS' royalty claim on a lump sum "buydown" payment. In In re Century Offshore Management Corp. (Century Offshore), 111 F.3d 443 at 445 (6th Cir. 1997), the court concluded that

the transaction, viewed as a whole, was clearly linked to gas "production saved, removed or sold," and we therefore reverse the decision of the courts below. An up-front payment made in exchange for a substituted contract that changes the price of the old contract, followed by new purchases, is a sufficient cause of new production to qualify as "production sold" under the Act.

In Century Offshore, the parties debated regarding whether the settlement agreement was a buydown or a buyout. In construing the agreement, the court concluded: "The lump sum payment behaved as an advance payment under a substituted requirements contract. As a result, the payment was for 'production sold' under the statute, and the royalty was payable when

the gas was produced." *Id.* at 448. The court specifically held that its decision in Diamond Shamrock, *supra*, was "not to the contrary" and that the decision in IPAA "does not compel a different result." *Id.* at 449. The court then reviewed the "necessary nexus to production" principle introduced in Diamond Shamrock and held that such nexus was present. ^{1/} The IPAA construction requiring a link between royalties and physical severance was also found to be satisfied. *Id.* Certiorari of Century Offshore was denied by the United States Supreme Court on January 26, 1998. U.S. , 118 S. Ct. 880 (1998).

We find that the Lakewood Compliance Division, MMS, acted properly when it directed Western to pay royalties and late fees. Its actions were reasonably based in the governing statutes and regulations. Moreover, its actions were not contrary to the courts determination in Diamond Shamrock and IPAA, as was manifested in Century Offshore. It simply recognized the need, pending a final policy resolution in an on-going debate over a broad, general issue, to continue its royalty administration in an orderly and regular manner. This Board's statement in Pacificorp, 95 IBLA 16, 19 (1986), with respect to unsettled issues regarding the readjustment of Federal coal leases applies to the audit of the settlement agreements in this case:

Congress intended that the statutes and regulations under which these leases are administered grant the same rights and impose the same obligations in Montana as they do in Wyoming or any other state in which the leased deposits are situated. If the agency were to interpret a statutory requirement in one way for a Montana lease and in an opposite way for a Wyoming lease, the agency's action would be arbitrary and capricious by definition.
* * * It would be arbitrary and capricious if we failed to make similar disposition of the instant appeal.

^{1/} Prior to issuance of Century Offshore, the Tenth Circuit Court of Appeals had the occasion to review a settlement payment involving a State of New Mexico lease and applied the same principles. Harvey E. Yates Co. v. Powell, 98 F.3d 1222 (10th Cir. 1996). It reasoned that Diamond Shamrock, IPAA, and other cases produced three guiding principles:

"First, royalty payments are not due under a 'production'-type lease unless and until gas is physically extracted from the leased premises. Second, nonrecoupable proceeds received by a lessee in settlement of the take-or-pay provision of a gas supply contract are specifically for non-production and thus are not royalty bearing. Third, any portion of a settlement payment that is a buy-down of the contract price for gas that is actually produced and taken by the settling purchaser is subject to the lessor's royalty interest at the time of such production, but only in an amount reflecting a fair apportionment of the price adjustment payment over the purchases affected by such price adjustment."

98 F.3d at 1231. The last principle iterated in Harvey E. Yates Co. v. Powell was applied by MMS in its review of the settlement agreements now before us.

MMS correctly found a royalty due for the amounts paid in settlement of the take-or-pay dispute between Western and El Paso to be a buydown agreement.

It found all the necessary elements for linking gas produced with the lump sum payment present in the agreement. Such were the instructions provided by the statutes, regulations, and the decisions in Diamond Shamrock and IPAA. To have acted differently would have been arbitrary and capricious.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 C.F.R. § 4.1, the Acting Associate Director's decision appealed from is reversed and the underlying order of the Lakewood Compliance Division, MMS, is affirmed.

R.W. Mullen
Administrative Judge

I concur:

C. Randall Grant, Jr.
Administrative Judge